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China's Economic Reforms: Performance and Prospects

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An Intelligence Assessment

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This paper was prepared by [redacted]
Office of East Asian Analysis. Comments and queries
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**China's Economic Reforms:
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Key Judgments

*Information available
as of 11 March 1985
was used in this report.*

China's already massive experiment with economic reform shifted direction and underwent a significant expansion in 1984. Whereas agriculture had been the focus of Beijing's attention since late 1978, the industrial sector was singled out for change last year, and an October Central Committee meeting convincingly demonstrated the party's heightened political commitment to reform of the economic structure.

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In an effort to spark long-absent industrial productivity gains, the leadership called for greater reliance on market signals and for a sharp reduction in the number of economic activities subject to mandatory state controls. Moreover, party bureaucrats were ordered to turn over day-to-day management of enterprises to qualified specialists.

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Although these new policies are decidedly *not* capitalist, they do represent a sharp break with traditional Marxist economic practices and, for that reason, remain controversial. Adoption of the new policies is evidence of a significant strengthening of reform elements of the party, led by Deng Xiaoping and General Secretary Hu Yaobang.

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Equally important, the changes reflect Beijing's perception of its economic performance over the past two years. A number of economic strengths in 1983-84 contributed to the greater commitment to reform:

- Agricultural output, which, in response to price changes and new economic freedoms, hit record levels both years. China has become a net exporter of cotton and the world's largest grain producer.
- Record 1984 output of coal and oil, China's primary sources of energy.
- Record exports, which gave Beijing a \$5 billion trade surplus in 1983 and a \$3-4 billion surplus in 1984.

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Reforms adopted in 1984 were also intended to address continuing problems in the urban/industrial sector:

- Inefficiency, waste, and quality problems persisted despite double-digit growth in both 1983 and 1984.
- Inadequate commercial and transportation systems proved incapable of handling agricultural surpluses, leaving grain to rot in the countryside.
- Party and state bureaucracies continued to meddle extensively in day-to-day business activity, stifling enterprise initiative and productivity.
- Increased subsidies to urban households contributed to six consecutive budget deficits totaling almost 65 billion yuan. (The average exchange rate in 1984 was 2.32 yuan per US dollar.)

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Most of the structural changes Beijing advocates are either in the earliest stages of implementation or still on the drawing board. Hence, we do not believe they had much direct impact on the economy in 1984. Nevertheless, China is probably already experiencing minor indirect benefits from bureaucratic reforms that seek to replace aging party, state, and enterprise managers with younger, better educated leaders. Moreover, the speed with which the party achieved a consensus on the recent reforms has created the appearance of top-level unanimity that may also have an impact on midlevel party bureaucrats charged with implementing the changes. [redacted]

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How China's economy will perform under the expanded reform policies in 1985 and beyond is an open question. Industrial output will probably again record sharp increases in 1985, perhaps as high as 10 percent. Pressure from Beijing will probably cause the number of firms operating in the red to decline this year, but we believe that at least 10 percent of state-run enterprises will remain in deficit until the Chinese can implement major price reform. We would view some increase in the unemployment rate as a sign that Beijing is serious about forcing inefficient workers and factories out of business. Political sensitivities, however, will probably dictate that any such increase will be small. [redacted]

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Predicting agricultural output is especially difficult this year. Besides the usual climatic uncertainties, Beijing is instituting major changes in pricing and procurement practices to get farmers more involved in grain transport, make them more sensitive to market needs, and reduce the size of government subsidies for agricultural products. The changes may dampen incentives to produce grain and cotton, a large share of total agricultural output. Whether the negative impact of these new policies will be sufficient to offset the productivity gains Beijing is still experiencing from earlier reforms is a major question Chinese policymakers will face in 1985. [redacted]

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On the negative side, we expect to see China struggling with several economic problems this year as a result of reforms. The October call for a rational price system reportedly sparked a few bank runs and some panic buying, both of which could recur this year as China experiments with various price adjustments. Increased—but still manageable—inflation is also probable as enterprises circumvent Beijing's demand that industrial price increases be absorbed through efficiency gains and not passed on to end users. [redacted]

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Over the longer term, we are cautiously optimistic about the potential effects of reform. We anticipate continued gains in the gross value of

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agricultural output—albeit not on the order of the 8-percent average annual increase achieved in 1979-84—as Chinese peasants begin using modern farming techniques. Despite the increases, China will probably continue to rely on supplemental amounts of imported grain to feed its coastal cities, thereby reducing the burden on the already hard-pressed domestic transportation system. [redacted]

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In the industrial sector, potential long-term gains from reform are enormous, because Chinese enterprises now are so inefficient and poorly managed. Beijing's emphasis on competition, its attempt to encourage individual initiative in commercial and industrial activity, and efforts to create an institutional environment conducive to these changes all bode well for long-term growth and efficiency gains. To achieve these benefits, however, Beijing must pass through a difficult transition stage—between tight central planning and a more market-oriented economy—during which it may confront many of the weaknesses of both systems. [redacted]

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Aside from economic implications, whether the reforms succeed or fail could have wide ramifications for both China's internal political climate and its international posture. And, so far, the outcome of these reforms is far from certain. We do not share the view, apparent in the Western press, that the changes have reached a point where they are irreversible; only a few elements of the reform program—all related to agriculture—have been implemented so successfully that they are no longer questioned within the government or party bureaucracy. In a worst case scenario, opponents of the market-oriented approach would seize upon new economic problems to successfully attack the reformist position. [redacted]

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Signs of serious public disorder that might arise, for example, as an urban reaction to too rapid price reform, are capable of doing the reform program irreparable harm. Sharply increased budget deficits would heighten policy-makers' concerns about inflation and could also damage long-term reform prospects. Lesser problems such as mounting economic crime, consecutive years of poor harvest, deteriorating terms of trade, or growing unrest over the acquisition of wealth by a small minority could combine to tip the scales against advocates of continued reform. Finally, prospects for continued reform hinge greatly on how much longer Deng Xiaoping remains politically active. Although he no longer involves himself in day-to-day management of economic policy, we believe Deng's strong support for the reform program has been the most important factor behind the reformers' recent gains. [redacted]

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China's Economic Reforms: Performance and Prospects

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Introduction

China's massive experiment in economic reform shifted direction and expanded significantly in 1984. Measures introduced during the year amounted to a broadside attack on the highly centralized economic structure adopted from the Soviet Union in the early 1950s. Declaring the rigid planning apparatus to be the major cause of industrial waste and inefficiency, Chinese reformers called for a reduction in direct government control, an end to egalitarianism, a cutback in party and state interference in day-to-day enterprise affairs, and total reform of the irrational price system.

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The Western press has called the reforms a return to capitalism, a characterization that, in our view, is incorrect. The state has shown no sign of relinquishing either ownership or control over major industries in China. Moreover, it is still making major investment decisions as well as hiring and firing top-level managers. By any objective standard, the structure of China's economy remains socialist.

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Nevertheless, the reforms do represent a sharp break with orthodox Marxist economic theory and practice. In fact, Chinese leaders have justified the changes by arguing that Marxism is incapable of solving all of China's economic problems. More accurately, the current Chinese experiment might be characterized as the most massive attempt ever made by a Communist country to supplement socialism with more market-oriented economic practices.

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Economic Results in 1983 and 1984—

A Mixed Picture

Much of what happened economically in China during the past two years reflected the successes and failures of Beijing's early experiments with economic reform. In the rural sector the earliest reforms—dating back to December 1978—included the “contract responsibility system,” which gave farmers effective control, but not ownership, of most of the land in China, and revised state procurement practices, which enabled farmers to sell above-quota production

at negotiated prices in free markets. In the industrial sector, enterprises were allowed to retain an increasing share of their profits, banks were encouraged to give loans in areas where the government had previously given grants, and small entrepreneurs were allowed to set up service-oriented businesses.

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Agricultural Production Up Sharply. Agricultural reforms were the centerpiece of China's effort to restructure its economy, and their success has encouraged the regime to push for even more radical departures from orthodox Marxist economic practices. The total value of agricultural output rose about 9 percent in 1983, more than double the 4-percent goal set in the annual plan. Growth in 1984 jumped almost 10 percent, well above the growth target Beijing needs to accomplish its goal of quadrupling the total value of industrial and agricultural output by the year 2000.

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Since the adoption of the responsibility system in late 1978, the Chinese have increased their annual grain production by 100 million tons—more than the entire annual grain production of Australia and Canada combined (see table). Grain output reached 387 million tons in 1983 and 407 million tons in 1984. The total was far larger than Beijing anticipated or was capable of handling effectively. In 1983 Beijing became the world's largest producer of grain and in 1984 produced enough corn to sell small quantities to its Asian neighbors. Concurrently, grain imports declined from 15 million tons in 1982 to less than 13 million tons a year later and then to only about 10 million tons in 1984. Cotton production showed even sharper increases of 29 percent in 1983 and more than 30 percent last year as China shed its role as one of the largest cotton importers and began small-scale raw cotton exports. Shipments of US cotton to China were indicative of this trend, falling steadily from a peak level of \$700 million in 1980 to almost nothing in 1984.

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China: Output of Selected Agricultural Products		Million tons					
		1979	1980	1981	1982	1983	1984
Total grain		332.1	320.6	325.0	353.4	387.0	407.1
Of which:							
Rice		143.8	138.9	144.0	161.2	168.9	170.0
Wheat		62.7	55.2	59.6	68.4	84.4	88.5
Corn		60.0	62.6	59.2	60.3	68.2	66.5
Cotton		2.2	2.7	3.0	3.6	4.6	6.1
Tobacco		0.8	0.7	1.3	1.8	1.4	1.2

presently be surplus, Beijing hopes to achieve significant productivity gains as a result of this trend. By the end of the century the government plans to have about 40 percent of the rural labor force engaged in nonagricultural production. [redacted]

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Overall, the sharp gains have left the peasantry much better off than it was in 1978. Rural residents have seen their annual per capita income more than double over the period to about 300 yuan. Moreover, the gap between rural and urban living standards has narrowed significantly. Consumption by city residents rose at an annual rate of 7.2 percent between 1979 and 1983, while rural consumption shot up 14.7 percent annually. Consumer goods such as televisions, washing machines, watches, and fans are now beginning to find their way into the rural areas, albeit at a slower pace than the increasing rural demand. [redacted]

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China credits its experiment with market-oriented rural reforms for the agricultural gains, although we believe better-than-average weather and price increases also played important roles.¹ The contract responsibility system, which gave peasants effective control over acreage for periods of 15 years or more, clearly sparked rural enthusiasm. The government's 1978 decision to hike procurement prices for agricultural products also contributed to output increases and led to improved rural living standards. With procurement prices now 40 percent higher than in 1978, peasants have been willing to increase their use of fertilizer and other inputs, further boosting agricultural yields. [redacted]

Beijing is also touting the reforms for their impact on rural employment. In pursuit of profits, an increasing number of unemployed and underemployed peasants have begun to engage in either commercial activities in the service sectors—opening restaurants, repairing shoes, making clothing, cutting hair, and so forth—or in production of handicraft items. Premier Zhao Ziyang recently stated that in rural areas in Guangdong and southern Jiangsu some 60 to 80 percent of the rural labor force has moved into industrial, sideline, or service occupations. Because as much as two-thirds of China's rural labor force of 350 million may

Energy and Transportation—Better Than Expected. The energy sector provided Chinese policymakers with what was perhaps the most pleasant surprise of recent years. Primary energy output rose 6.7 percent in 1983, the fastest pace in five years, and the increase in 1984 was probably closer to 8 percent. When energy saving measures are included, the gains come to more than 9 and 11 percent, respectively. [redacted]

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Crude oil output, which hovered between 102 and 106 million tons annually between 1978 and 1983, shot up 8.5 percent in 1984 to a record 115 million tons. Production of coal, China's largest energy source, rose 7.7 percent. Much of the increase in oil production came as a result of improved recovery processes and new finds in the Shengli and Daqing oilfields. Both oil and coal benefited from a new incentive system that allowed producers to market above-quota production at higher prices. New taxes on energy consumption and the higher prices for above-quota production contributed to China's still modest energy conservation efforts. The only negative development in the energy sector last year came in hydropower production, which remains at 1983 levels as a result of regional water shortages (see figure 1). [redacted]

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¹ Although some Western experts choose to consider the price adjustments of 1979 and 1981 as part of the economic reform, the Chinese usually categorize them separately. Beijing has adjusted prices periodically over the past 30 years and, by themselves, the changes neither require nor presage structural reform. [redacted]

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Figure 1
China: Energy Output Since Reform, 1979-84

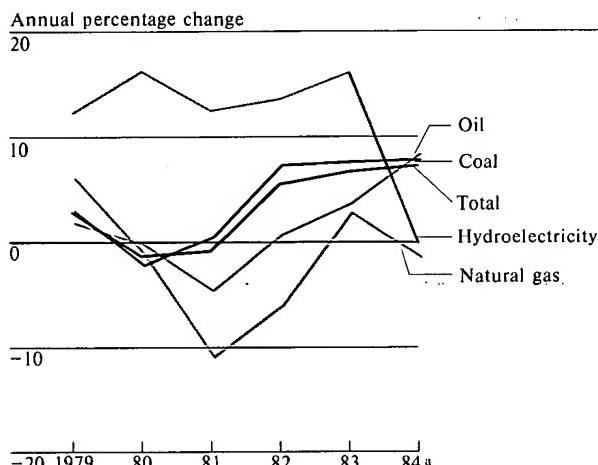
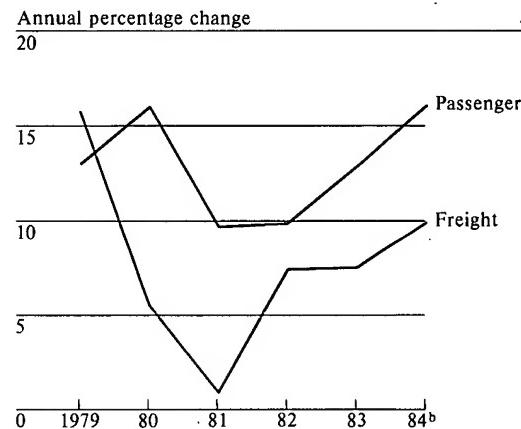
^a Preliminary.

Figure 2
China: Volume of Transportation Traffic Since Reform, 1979-84^a

^a Index measured in passenger- and ton-kilometers.^b Preliminary.

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The transportation sector also achieved good results when measured against the low level of resources that Beijing devoted to it over the past few years. The 7.6-percent increase in ton-kilometers of goods transported in 1983 and the 10-percent gain last year came mainly from improved management of existing facilities. Burgeoning budget deficits starting in 1979 forced Beijing to scale back its budgetary outlays, and investment in transportation was especially hard hit. The share of total investment in capital construction going to transportation and telecommunications dropped from an already low average of 18 percent in the 1971-75 period to 13 percent in 1976-80 and to 9 percent in 1981. Beijing raised the proportion back up to 13 percent in 1983 and 14 percent last year, but clearly the rate of investment is far short of China's needs (see figure 2). [redacted]

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Foreign Trade—A Growing Surplus. The foreign trade sector has grown significantly under China's open-door policy. Exports in 1983 rose only 2 percent to \$24 billion, but rose nearly 15 percent in 1984 to a

record \$27 billion. Imports showed a 10-percent increase in 1983 before surging as much as 30 percent last year.² The \$3-4 billion 1984 trade surplus was China's fourth consecutive large surplus, putting Beijing under increasing criticism from Western trading partners (see figure 3). [redacted]

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Total foreign exchange holdings at yearend 1983 amounted to an unprecedented \$20 billion, 10th largest in the world and seventh largest if only foreign exchange is considered. Reserves continued to rise in 1984. We estimate the debt service ratio last year was only about 5 to 6 percent, one of the world's lowest. Until late last year, Beijing had been exceedingly cautious about accumulating debt or spending its reserves, despite an obvious and growing need for Western technology. This reluctance to make major

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Figure 3
**China: Foreign Trade Since Reform,
 1978-84**

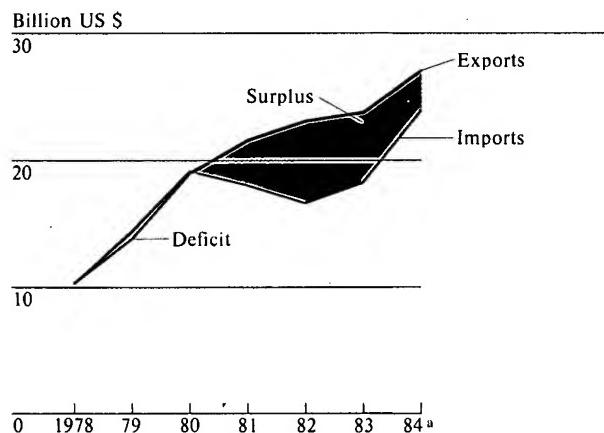
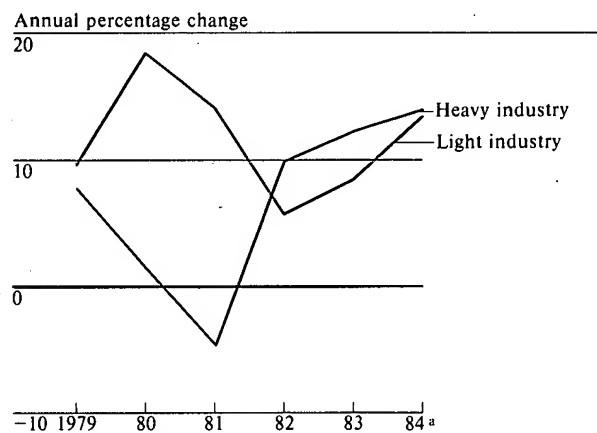
^a Estimated.

Figure 4
**China: Value of Industrial Production
 Since Reform, 1979-84**

^a Preliminary.

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outlays for Western equipment stemmed from several factors, including Beijing's uncertainty about which projects warrant top priority, domestic financial problems, and bureaucratic constraints on the use of foreign exchange. Beginning in November 1984, however, Beijing launched a program to acquire Western equipment for development projects, signing more than \$10 billion in contracts in the space of just three months. [redacted]

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Industrial Performance—A Different Story. China's industrial performance, when measured in terms of total output, also appeared more than satisfactory. The total value of industrial output rose 10 percent in 1983 and at an even faster clip of 14 percent in 1984, well ahead of the planned growth rates of 4 and 5 percent, respectively. Half of total output originated in the light industrial sector—where China believes its major potential lies—as opposed to only 42 percent in 1978, when China began its experiments with industrial reform (see figure 4). [redacted]

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Despite the apparent gains, Beijing considers its early industrial reforms a failure. The program was supposed to address serious problems of waste and inefficiency, and Beijing openly declared its willingness to sacrifice growth while reforms worked their magic. The Sixth Five-Year Plan (1981-85) called for average annual increases in industrial output of only 2.7 percent, but demanded accompanying decreases in per unit output costs of 1 to 2 percent. Actual results so far, however, have shown industrial output growing at an 8.7-percent annual clip and costs actually rising in 1982 and 1983 before leveling off last year. [redacted]

Product quality has also failed to improve markedly under reform, and labor productivity in the industrial sector remains low. Furthermore, despite the five-year reform effort, one-fifth of China's industrial capacity is idled by electricity shortages, even while China's enterprises use, by some estimates, as much as three

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and a half times more energy per unit output than the average LDC. Much of the output produced at this high cost is shoddy and outdated. For example, only 10 percent of the machinery and equipment produced is up to modern standards; the rest, the Chinese claim, is 1950s and 1960s vintage.

Mounting Problems Associated With Reform. A host of serious new economic problems arose in the wake of piecemeal reform policies. Early efforts to devolve decisionmaking authority to the factory level, for example, threatened to untrack China's high-priority infrastructure investment program. Enterprise managers, using their authority to make capital investment decisions, ignored government pleas to hold the line on industrial investment. Between 1979 and 1982, extrabudgetary investment in capital construction more than doubled to 28 billion yuan before leveling off in 1983 and 1984. The increase not only drained funds needed for infrastructure investment, it also left China short of cement, glass, and other construction supplies. Furthermore, much of the investment money flowed into housing construction, which did little for China's productive capacity. Where extrabudgetary investment went to machinery and equipment, in many cases it was for small projects that, when operational, began attracting raw materials needed by larger, more efficient state-run enterprises.

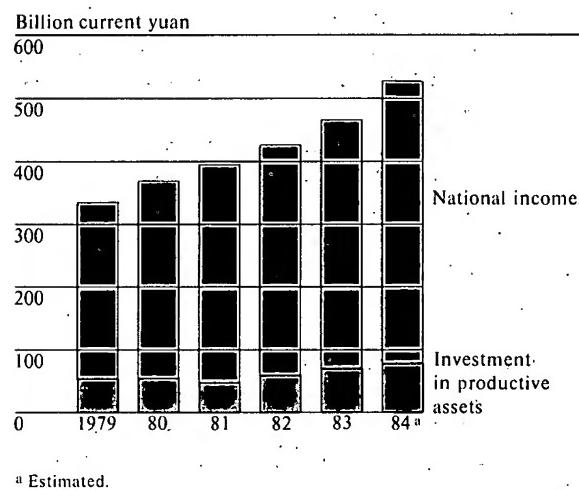
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More serious, in the view of some Chinese leaders, the failure of the initial industrial reforms also threatened to limit China's long-term growth potential. Beijing was counting on productivity gains from industrial reform to offset the impact that falling investment rates would otherwise have on long-term growth. But this has not happened. With the sharp upswing in residential building, nominal investment in productive assets has risen at only a 5.6-percent annual pace since 1979, compared with 9.8-percent growth in nominal national income (see figure 5).

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Efforts to decentralize decisionmaking authority created financial problems that also threatened the reform program. The fiscally conservative government had to reconcile itself to five consecutive budget deficits between 1979 and 1983 totaling about 58 billion yuan. Another deficit, perhaps as large as 6 billion yuan, is anticipated this year. Treasury bonds

Figure 5
China: Investment as a Share of National Income, 1979-84



^a Estimated.

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were used to help finance the red ink without resorting to the inflationary printing of money, but the government has grown increasingly concerned about its inability to balance revenues and expenditures.

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On the revenue side, budget shortfalls stemmed in part from the decision to cut back growth in heavy industry, the major revenue generator. When heavy industrial output leveled off in 1980 and then declined in 1981, revenues suffered. And when the government tried to spark productivity by introducing a tax system that would allow enterprises to retain more of their profits, many enterprises began understating profits and overstating costs to avoid tax payment. The China Audit Administration, set up in September 1983 to monitor the situation, found errors and violations amounting to more than 600 million yuan in its first year of operation.

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Even successful agricultural reforms compounded financial problems on the expenditure side. Procurement prices for agricultural products were increased sharply beginning in 1979 to boost rural incomes, while consumer prices for those products went relatively unchanged. The result was a huge gap requiring more than 140 billion yuan in price subsidies between 1979 and 1983. Price subsidies alone took nearly one-fourth of total state revenue by 1983 and more than offset the defense and investment cutbacks that were part of the government's budget-balancing efforts between 1980 and 1982. The problem probably worsened in 1984, given the further surge in agricultural output. [redacted]

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The inability of the urban reforms to keep pace with rural changes also threatens to undermine recent agricultural gains. The sharp increases in grain and cotton output began surpassing Chinese commercial distribution capabilities in late 1983. By 1984 most major grain-producing provinces had sizable stockpiles of grain rotting outside storage facilities. Jilin Province, for example, has reported that it now has 5 million tons of unwanted grain. [redacted]

Factors Behind China's Mistakes

Given the magnitude of the changes Beijing introduced, the emergence of serious problems was not surprising. But, on several counts, the government's piecemeal approach exacerbated existing difficulties. For example, rather than introducing a comprehensive, well-considered program, the industrial management reforms began as an experiment and then spread almost of their own volition. In 1979 about 4,000 enterprises throughout the country were allowed to experiment with decentralized decisionmaking. Less than a year later, 16 percent of all enterprises under the state budget—producing 60 percent of the total value of output and earning 70 percent of the profits—had been given expanded decisionmaking authority. In our view, neither party officials nor central authorities were prepared to surrender authority on such a large scale on such short notice. Misunderstanding and bureaucratic infighting became major problems. [redacted]

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Lacking a comprehensive plan, Beijing was forced early to make major alterations in the reform program. The frequent changes led factory managers to

question the government's commitment to reform and, hence, slowed implementation. For example, the government repeatedly altered its tax policy and demonstrated a great deal of uncertainty over how much autonomy local-level enterprises should have in distributing bonuses and in making investment decisions. For factory managers who survived China's Cultural Revolution by resisting any policy changes that deviated from orthodox Marxism, the government's vacillation was a signal to go slowly in implementing change. [redacted]

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Beijing's most serious problem in promoting a transition to a more market-oriented economy was its failure to come to grips with its irrational price structure. Aside from the financial problems this generated, the price structure—large parts of which date from the 1950s—conveyed no meaningful information on which economic decisions could be made. Since prices bore little relationship to production costs, enterprise losses were not necessarily attributable to either inefficiency or lack of demand. Beijing's insistence, therefore, that enterprises make profits had little realistic effect, as the government had no criteria for determining which enterprises should be forced into bankruptcy. By yearend 1983, one-fourth of all state enterprises were operating in the red. [redacted]

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Outdated fixed prices, moreover, meant that firms had no means of assessing their most profitable economic endeavors. Enterprises producing high-priced goods requiring cheap inputs, for instance, made large profits regardless of efficiency or product quality. Arbitrarily high Chinese procurement prices on rolled steel, for example, guaranteed 20- to 30-percent profit margins on many products, regardless of quality, with some profit margins as high as 60 to 70 percent. Even when there was no consumer demand for a firm's output, profits were assured by the state's practice of procuring the commodity at the arbitrarily established price. A study of 32 enterprises in Liaoning Province disclosed that 47 percent of all goods produced in 1983 were unmarketable or already overstocked; inventories of rolled steel nationwide reportedly now exceed 20 million tons. At the same

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time, the production of many important, but low-priced, industrial materials (especially iron ore, pig iron, and cement) and popular consumer goods (notably cotton clothing and furniture) began declining despite strong demand, because such items yielded little or no profit. [redacted]

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Nor could China's banking system help in the transition. During the Cultural Revolution the People's Bank of China operated primarily as a cashier/accountant for the Ministry of Finance. The major function of the bank was to transfer funds at the Ministry's bidding. Loans were made to meet plans regardless of the borrower's financial status or the expected rate of return of the project. Interest charges were held low, when assessed at all, and repayment was seldom enforced. The upshot of this policy was intense pressure from enterprises to secure funds for investment, without regard to the possible financial returns. [redacted]

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Finally, the environment in which the seeds of industrial reform were sown was much more hostile to change than that of the agrarian sector. Rural reforms gave agricultural decision making authority back to the farmer, but urban reforms handed authority to factory managers who were ill equipped for their jobs. Most acquired their positions on the basis of political criteria, not managerial talent. They lacked both the education and the expertise necessary to function in a competitive environment. Hence, it was not surprising that, for example, when Beijing gave managers the power to reward outstanding work with bonuses, payments were usually made on an egalitarian basis, across the board. [redacted]

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Pushing Ahead With Reform—

The 1984 Policy Shift

Economic policy has been highly contentious politically, and serious disagreements over reform reached all the way to the Politburo Standing Committee. [redacted]

[redacted] Politburo elders Chen Yun and Li Xiannian favored a gradual approach to economic change, with extensive reliance on comprehensive central plans, supplemented in a very minor way by market forces. This approach was also clearly favored by most of China's economic administrators and planners. Premier Zhao Ziyang and party General Secretary Hu Yaobang, supported by many of

China's leading economists, however, favored a more radical approach. They insisted that many of the problems associated with earlier reforms came about because the measures had not gone far enough in freeing up market forces. Hence, they favored more sweeping institutional changes to support reforms already in place. [redacted]

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This debate—carried on from about 1980 to 1983—gave China's economic policies something of a seesaw character and adversely affected the implementation of even agreed-upon policies. In 1983 it appeared that conservative opponents of reform were in command. The economic literature focused on the importance of planning and on the "supplementary" role that the market should play. [redacted]

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In early 1984, however, the political momentum shifted decisively in favor of the reformers. Several factors account for this change. The backlash against the conservative-backed campaign to "eliminate spiritual pollution" in late 1983 benefited Hu Yaobang and other party "liberals," while damaging the reputations of elderly conservatives, such as Chen Yun. Hu and Zhao took their case to the provinces in early 1984 and generated a good deal of local party enthusiasm for expanded reform. Most important, Deng Xiaoping reiterated his support for economic and political reform and gave the State Council and Secretariat the wherewithal to develop and implement new policies. [redacted]

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In January, Beijing issued Central Document No. 1, a comprehensive summary of rural reform measures and a clear call to expand the reforms. It gave more opportunities to farmers to engage in commerce and "commodity production." In April the State Council issued new regulations permitting factories and commercial enterprises to experiment with new wage programs. Less than a month later, the "Provisional Regulations on Greater Freedom for State-Owned Industrial Enterprises" were published, giving enterprises the right to:

- Produce whatever goods are in short supply after fulfilling state plans.

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- Adjust retail prices for industrial machinery within a range of 20 percent around the state price.
- Decide what share of their income will go to production, expansion, reserves, or bonuses.
- Recruit technical specialists directly and develop pay standards.

Although many of these measures were little more than restatements of policies Beijing had experimented with during the previous three years, they signaled a renewed commitment to industrial reform. [redacted]

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Zhao Ziyang's address to the May 1984 session of the National People's Congress (NPC) gave official confirmation to the policy shift. After a brief note of praise for agricultural reforms, Zhao devoted most of his speech to the "urgent" need for "quickening" reform in the cities. Specifically, Zhao called for:

- Implementation of the second stage of China's tax reform program to give enterprises even greater financial autonomy.
- Experimental restructuring of the managerial system in the construction industry, replacing financial appropriations with bank loans, using public bidding procedures to issue contracts, and revamping the material distribution system to alleviate shortages.
- Better utilization of educated technicians in the planning and management process in enterprises.
- Reform of the commodity circulation system to facilitate the flow of goods between town and country, and the exchange of goods between different regions. [redacted]

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About the same time, various Chinese media were publishing articles calling for experiments with market-oriented practices, such as forcing state banks to compete against each other for deposit and loan business, and allowing domestic enterprises to issue stocks, bonds, and other securities. Perhaps the most notable shift, however, was the emergence of a host of articles, by economists as well as policymakers, advocating an early resolution of the price problem. Prior to this—despite the view widely held by Western and Chinese economists alike that the entire experiment with market tools could not succeed within the framework of China's irrational prices—only the most

daring advocates of economic reform suggested moving quickly to tackle the potentially explosive issue of price reform. [redacted]

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Changing the Planning Apparatus—State Council Regulations. In early October the State Council issued "Provisional Regulations Regarding the Improvement of the Planning System," which called for a sweeping overhaul of China's planning apparatus. Although the document itself remains publicly unavailable, it is clear from Chinese press accounts that the State Council used the regulations to attack one of the main sources of economic inefficiency in China, overcentralization. [redacted]

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The regulations called for a drastic reduction in the number of commodities controlled by mandatory state plans. Only about 60 industrial goods and fewer than 10 agricultural and sideline products will be subject to state purchase quotas in 1985,³ compared with more than 250 controlled goods in 1980. Provincial authorities, taking their cue from Beijing, are also cutting back on the number of goods they control under mandatory plans. Hubei, for example, reported that mandatory plans now apply to only 43 products compared with 177 products in the past. Most goods are from now on subject to "guidance plans," where the state or local authorities recommend output levels and use economic levers—tax incentives, interest rates, lending policies, and so forth—to encourage enterprises to reach preestablished goals, but where enterprises may *for economic reasons* ignore government goals without fear of reprisal. In addition, the regulations allow production of certain agricultural goods to be determined totally by market forces. [redacted]

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Enterprises engaging in foreign trade or seeking foreign capital were to adhere to guidance plans giving them greater flexibility in their negotiations with foreigners. The state, however, retained a significant

³ China recently published a partial list of the commodities subject to mandatory plans. Included were coal, oil and petroleum products, steel, nonferrous metals, timber, cement, chemicals, electricity, munitions, and other items. Agricultural products on the list included cereals, cotton, edible oils, tobacco, pigs, and some aquatic products. [redacted]

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amount of control by dictating that all foreign exchange transactions must be carried out through the state-run Bank of China and, hence, are subject to the bank's tacit approval. [redacted]

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Beijing also reaffirmed its commitment to tight control over domestic investment decisions—a power it temporarily lost in 1981 when extrabudgetary investment surged despite government efforts to hold it in check. The Provisional Regulations required that the general scale of investment in fixed assets must grow according to a state-set schedule. Although enterprises continue to have some authority to borrow and to draw on a portion of retained profits for investment purposes, the new planning apparatus clearly calls for much stronger government leverage in investment decisions. [redacted]

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The Party's Endorsement—The Third Plenum. Perhaps the reformers' crowning achievement of 1984, the strongest evidence of their increasing strength, came during the Third Plenary Session of the Communist Party's 12th Central Committee. After six days of "preparatory meetings," the one-day plenum endorsed a comprehensive "Decision on Reform of the Economic Structure," a document encapsulating the bulk of the earlier changes.⁴ Although the decision is neither a major turning point in economic policy nor a surprising announcement of some historic new trend, it does represent a political decision to throw the entire weight of the party behind reform of the economic structure. [redacted]

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The major aspects of reform that the party committed itself to in the plenum document are:

- Instituting rational prices.
- Carrying out the planning changes introduced in the State Council regulations earlier in the month.
- Removing state and party bureaucrats from most day-to-day business decisions.
- Expanding enterprise managers' responsibility and accountability in hiring, firing, finance, and production practices. [redacted]

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Although the new program calls for a weakening of the role played by state bureaucracies, their power, nevertheless, remains significant. In addition to the continued importance of the central planning apparatus and strict control over products of national importance, the state will continue to appoint and remove key enterprise managers and thus exert a powerful, if indirect, influence on production decisions. Moreover, when enterprises experience financial problems, the state will determine which firms will be subsidized and which will be forced to merge or shut down. [redacted]

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The plenum marked the end of the party's reluctance—perhaps for fear of sparking potentially destabilizing inflation, hoarding, and speculation—to come to grips with the problem of irrational prices. Concluding that failure to deal with the price structure would jeopardize the entire reform program, the plenum document explicitly recommended establishment of a "rational price system," calling it the key to reform of the entire economic structure. The fact that Beijing hopes to have its irrational price system "basically" corrected in only five years is an indication of the party's commitment to rapid reform. [redacted]

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The Short-Term Outlook

Beijing views 1985 as a critical year in its overall reform effort. Likening the series of measures launched in late 1984 to an all-out war on economic problems, a recent front page *People's Daily* article called 1985 the first battle, which, if not carried out successfully, "greatly increases the difficulties in future combat." [redacted]

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Structural changes that Beijing now has on the books to rectify problems in the industrial sector came too late to have a direct impact on the economy in 1984, and it is not clear how important they will be in 1985. The shift of emphasis to urban reform was only about six months old by yearend 1984, and most of the major policy changes, particularly price and wage reform, are still not in place. Even important programs that Beijing has been planning for some time, such as the effort to substitute tax payment for profit delivery, were new enough that their effect has probably not yet been strongly felt. [redacted]

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Nevertheless, we believe that Beijing is already experiencing minor benefits from its bureaucratic reforms and that in 1985 productivity gains will be even more apparent. Some improvement will come from intangible factors, such as success in replacing aging party, state, and enterprise bureaucrats with younger, better educated leaders. The appearance of unity at the top that the party conveyed in 1984 by being able to push through major reforms should also help enlist the support of the many midlevel bureaucrats who previously resisted or ignored reform on the assumption that it would be short lived. Once this group turns its attention to increasing profits and limiting losses, some efficiency gains are possible even without major structural change. [redacted]

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Given the more competitive climate and the administrative emphasis on economic results, further strong gains in *industrial output* are probable again this year. A vice chairman of the State Economic Commission recently told Western businessmen that GNP would probably rise between 8 and 10 percent in 1985. As pressure from Beijing builds, the share of enterprises operating in the red should decline, although we estimate at least 10 percent of state-run enterprises are probably dependent on price reform to push them into the black. Another sharp increase in energy output also appears probable: Beijing expects oil, coal, natural gas, and total electricity output each to hit new records in 1985. [redacted]

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Predicting *agricultural output*—always difficult because of the importance of the weather—may be especially hazardous in 1985 in light of policy changes that have been announced since the beginning of the year. The burden that China's grain subsidies have placed on the domestic budget has made Beijing somewhat ambivalent about recent record harvests. To alleviate the financial problem and to slow the buildup of unusable grain inventories in the countryside—where the inadequate commercial and transportation systems have limited Beijing's procurement capabilities—Beijing is initiating a program that would effectively lower the price paid for above-quota grain production. In addition, the government has adopted measures that require peasants to take on a greater share of the burden of transporting and marketing all types of agricultural output. Both policies will have a dampening effect on production which

could be felt beginning in 1985. It is unclear, however, whether this effect will offset the positive factors that led to the major increases in output over the past five years. [redacted]

As Beijing moves to implement its difficult structural changes, other major dislocations are probable. The next two years will see the Chinese economy in the midst of transition between tight central planning and a more market-oriented socialism. During this period Beijing may find itself in the worst of both worlds. [redacted]

Introducing rational prices into China's shortage-driven economy probably is the most essential element of the current reform and, at the same time, the element posing the most immediate threat—*inflation*. The plenum's call for price reform reportedly sparked a few bank runs and some panic buying late last year, despite government assurances that prices would be adjusted slowly and that consumer income would not be allowed to suffer. The potential for trouble increased markedly in 1983 as urban and rural consumers, unable to satisfy their demands because of shortages, increased savings by a sharp 32 percent. Preliminary data show a further 18-percent rise last year to more than 100 billion yuan, five times the prereform 1978 level. As Beijing attempts to bring prices in line with costs for essential goods such as cereals, industrial raw materials, and coal, Chinese savers may generate considerable inflationary pressures by attempting to turn their massive deposits into consumer goods and housing. [redacted]

Beijing is committed to immediate price adjustment, but it also clearly recognizes the potential for panic that price reform raises and will move deliberately to implement changes.⁵ In fact, we believe the risk that the leadership will move too slowly with essential price adjustments (and stall the entire reform package) is as great as the risk that too rapid an advance will spark economic instability. Nevertheless, it is safe to assume that price reform will be somewhat inflationary in the short run. Most adjustments will probably be upward, and important products such as coal,

⁵ In a New Year's Day address, Zhao Ziyang quoted Deng Xiaoping on the method of implementing price reform, saying, "We must take one step and look around before taking another." [redacted]

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oil, and certain foodstuffs will eventually have to undergo steep revisions. The reforms may occasionally spark bouts of panic buying to which Beijing will most probably respond by limiting bank withdrawals, by ordering producers to hold the line on prices, by ordering consumers to limit buying, and by raising interest rates and taxes to discourage consumption.

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Another economic hurdle that the leadership must cross in the immediate future is the question of *enterprise bankruptcy*. In 1983, nearly one-fourth of China's industrial enterprises were unprofitable, and last year, even after the government exerted strong pressure for improvement, 16 percent were still operating in the red. Clearly, Beijing cannot allow a massive shutdown of such a large portion of its industrial base. Furthermore, until reform is in place, there is no effective way of determining which enterprises deserve closing. Despite the fact that subsidization of losing enterprises encourages inefficient behavior all around, we believe Beijing will probably be cautious and allow a large number of inefficient firms to continue to operate.

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Where the government decides some firms must be forced to close, the accompanying *unemployment* problems may be locally destabilizing. The Chinese have built up an impressive array of controls—including housing and food rations and tough employment restrictions—to prohibit the free movement of population from the countryside to the cities and from smaller, poorer cities to larger, more wealthy ones. Beijing is now attempting to relax these restrictions somewhat to encourage labor mobility, but the barriers are coming down slowly. For the near future, if major industries are allowed to fold, certain geographic areas could face high unemployment rates. We believe this unemployment threat will reinforce Beijing's inclination to go slowly and to accept temporary inefficiency.

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In light of these and other serious problems—the shortage of trained administrators and technicians, continued population pressures, inadequate transport and communications systems—we do not expect the short-run benefits of urban reform to match those experienced under the agricultural reform program. But neither does Beijing. The government is allowing itself five years to get the program in place and

probably will hail even minor improvements in efficiency during that period as evidence of progress. The fact that Beijing is going into this program with its economic eyes open increases the probability of success.

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Longer Term Prospects

The Agricultural Sector—More Gains. Despite problems that agricultural surpluses have created, Beijing realizes that its per capita consumption of food products is still one of the lowest worldwide, and it is eager to pursue policies that will boost long-term output. How successful the Chinese will be in this regard depends critically on several factors. In agriculture many of the productivity gains accompanying the introduction of the contract responsibility system were onetime achievements. Future gains will probably come more slowly as farmers gradually introduce new technology and as marginal land is better utilized. Weather will also remain a major unknown. Although Beijing's 1983 gains came in the wake of one of the worst weather years in recent times, in general the reform years have met with better-than-average weather. We believe that consecutive years of widespread natural disaster could cut crop yields dramatically, especially if laborers under the contract responsibility system resist leaving their own plots to engage in irrigation system repair or rescue operations that may not be directly beneficial to them.

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Other factors, however, bode well for continued improvement in agricultural productivity. China is now investigating methods of educating its peasant population on agrotechnology advances that have occurred over the past two decades. Agricultural extension services are trying to popularize more effective use of pesticides and compound fertilizers. Beijing is using economic levers to encourage peasants to grow crops most suitable for their regions and to use modern equipment. Purchases of farm machinery are on the rise, showing nearly a 12-percent increase in 1984. The number of tractors, combines, and trucks involved in agricultural production has more than doubled since 1979. In addition, the rapid increase in production of consumer durables will continue to

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motivate Chinese farmworkers. Commercial reforms that speed the delivery of farm goods to urban markets and urban goods (including fertilizers, machinery, and consumer goods) to the rural sector will also help. [redacted]

On the whole we believe the positive factors outweigh the negative, and we anticipate long-term gains in the value of agricultural output of about 5 percent per year. The gains should enable Beijing in most years to devote the bulk of its foreign exchange reserves to equipment and technology rather than to agricultural imports. Nevertheless, as both rural and urban incomes expand, food consumption will also rise. Beijing expects an especially sharp increase in demand for meats and processed foods. This—combined with the massive problem China already has in moving grain to urban consumers—will, we believe, result in continued purchases of US grain, even in years of better-than-average weather. Poor climatic conditions in consecutive years would probably deplete grain reserves and bring China back into world markets in a big way. [redacted]

Industry—Major Obstacles Ahead. Long-term success in the industrial sector depends heavily on how fast and effectively some of the new reforms can be implemented. Despite Deng's efforts, there is still considerable opposition within the party bureaucracy to further expansion of the reforms. There are those with grave ideological reservations about the program and those who fear that Deng's concomitant demand that the party upgrade the expertise of party leaders, as well as enterprise managers, will cost them their jobs. Their fears were justified in mid-1984 when Organization Department Chief Qiao Shi stated that 40 percent of all managers and 70 percent of all party committee members in 3,000 key enterprises would be replaced this year. Because the task of implementing new reforms rests heavily on these midlevel cadres, we expect progress to be neither smooth nor rapid, as they seek by various bureaucratic methods to impede the progress of changes they view as threatening. [redacted]

Beijing already has achieved some success in removing party cadres from the economic decision making process and installing trained technicians in their place [redacted]

[redacted] nearly 1 million veteran cadres have left their

posts since the government began its efforts to upgrade its managerial expertise and 2 million were to have retired by yearend 1984. Further progress in this political aspect of reform will improve the chances for overall success. [redacted]

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Other institutional changes needed to buttress reforms will probably continue to develop slowly. Despite major reforms in the banking system, there is evidence that local pressures, not economic factors, continue to determine the direction of loans. And, despite Beijing's decision to replace budgetary allocations with loans, only about one-third of the funds used for production come from banks. This suggests that, although improvements have been achieved, enterprises still lack the incentives necessary to force them to make efficient investment decisions. The productivity of capital is unlikely to show marked improvements until Beijing achieves better results with its banking reform. [redacted]

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Efforts to revitalize the commercial system may generate considerable efficiency gains. The difficulties that stem from China's inadequate road and rail system are compounded by bureaucratic problems that accompany tight state control over transport activities. Although it would take a massive investment program to eliminate China's transportation problems, we believe that the increased involvement of individuals and cooperative enterprises in middleman activities will alleviate a significant number of the distribution problems that now plague Chinese industries. [redacted]

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We anticipate that, over the longer term, if the reform program can be successfully implemented, devolution of the decisionmaking authority for hiring, firing, wages, and prices to managers will improve enterprise efficiency. As more enterprises are required to market their own products, quality will undoubtedly improve and a wider variety of goods can be expected on Chinese markets. Because small firms producing non-essential goods will be given the most leeway, they will probably be the first to show marked improvements. Progress within large, state-run enterprises

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producing major goods will, we believe, occur more slowly. []

Despite some short-term problems as the government carries out price adjustment policies, we do not believe there is major risk of serious long-term inflation. For this to occur, the government would have to be willing to sustain the increases in consumer demand by printing money. Although some subsidies or wage increases will be offered in the early stages of the adjustment process—to help ease concerns about eroding purchasing power—the fiscally conservative government is unlikely to resort to long-term use of the printing press to finance consumer spending. []

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On the whole, we believe the current reform will lead to some efficiency gains as early as next year. Although Beijing will probably be disappointed at the rate of progress, the fact that the economy is moving in the right direction, under a constant political climate, should give impetus to further change, leading to longer term productivity increases and stronger economic growth. Government efforts to encourage surplus labor to take up private commerce and service activities have considerable potential for increasing both agricultural and industrial productivity. The renewed emphasis on enterprise autonomy also bodes well for productivity increases, some of which will go unobserved in Beijing as enterprises attempt to underestimate profits to avoid taxes. []

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Whither Reform—Not Irreversible Yet

In the wake of the increasingly bold and successful Chinese economic policies, there has been a growing tendency on the part of Western observers to view the reforms as irreversible. We do not share this view. []

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Only a few elements of the reform program—for example, the dismantling of the communes and institution of the contract responsibility system—have been implemented successfully enough that their efficacy is no longer questioned by Chinese both inside and outside the party. Most economic changes—including price, management, banking, and tax reforms, as well as the opening up of the 14 coastal cities to Western business—remain controversial and unproven, and therefore vulnerable to political setback. []

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We see the next few years as providing the critical test of the program's survivability. If Beijing can cope with the major economic obstacles that are already beginning to appear, without resorting to the direct controls used in the past, then we believe the reform program may develop an impetus difficult to stop. In the meantime, however, it is not difficult to envision a series of circumstances that could derail the current program and lead the Chinese leadership to fall back to the more tightly controlled structure that existed prior to 1979. []

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The Best Case Scenario—And Some Indicators. Under the best of circumstances China's recent decisions to lower average procurement prices and to involve peasants in the distribution process would lead to a lessening of the financial burden that government procurement practices now impose without too precipitous a decline in output of major agricultural products. Temporary surges in retail prices are inevitable under the new agricultural program, and opponents of reform will be watching, with great interest, urban workers' reaction to the increases. If consumers accept the rises without forcing Beijing to offer large budget-damaging subsidies, reformers will have further strengthened their contention that macroeconomic behavior can be controlled using economic levers rather than direct state intervention. []

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A lessening of the financial burden of agricultural subsidies would place the government in an even better position to confront dislocations in the industrial sector. Ideally, Beijing would begin early to rationalize its major industrial prices. Energy prices will be among the toughest to adjust because of their impact on nearly every sector of the economy, but early steps at upward adjustment would be a positive sign of Beijing's desire to make its new program work. Further relaxation of price controls on minor industrial goods—allowing them to fluctuate somewhat in response to market conditions—would also bode well for the future of reform. []

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In the best case, Beijing would be able to limit the inflationary impact of its price adjustments by combining them with effective fiscal and monetary policies. Higher interest rates, limited growth in the

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money supply, and increased product taxes will have to be Beijing's primary methods of control. Continued experimentation with these tools should be viewed as a positive sign. Too quick or too heavy a reliance on direct government intervention would have an adverse impact on the reform program. [redacted]

Even before its price structure becomes "rational"—a process that in the best of circumstances may take a decade—Beijing must increase pressure on state-run enterprises to operate more efficiently. Ironically, perhaps the most positive sign of progress in this area would be an increase in the number of forced plant closings. This would demonstrate that Beijing is willing to accept increased rates of unemployment while modern factories replace outmoded ones over the transition period. Of course, any increased unemployment would have to be carefully managed in order to avoid major labor problems. [redacted]

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A further increase in imports of foreign machinery—provided it comes within China's financial and technological capabilities—would also be a positive sign. With its industrial base outmoded and periodically idled by energy shortages and its transportation sector in disarray, Beijing is in need of large amounts of Western equipment and technology. A sustained major import program would be a sign of confidence and probably would also have positive spillover effects on China's joint venture policy. Western reluctance to move rapidly into management deals with Chinese firms may dissipate once China becomes viewed as a major import market. [redacted]

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A final positive sign of the reforms' staying power would be further increases in the share of total output produced or transported by individual entrepreneurs. In our view, China must rely on this budding commercial sector to remedy commodity circulation problems that will be with China until its transportation system can undergo major modernization. [redacted]

The Worst Case. Under a worst case scenario, economic problems that are already beginning to surface would deepen and spread in a fashion difficult to control except by direct government intervention. Fear of price instability permeates the Chinese economic bureaucracy, and too serious a public reaction

to price reform would threaten the entire program. Recurring bouts of panic buying, bank runs, and, in the extreme, public disorder are all capable of doing the reform program irreparable harm. [redacted]

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Sharply increased budget deficits would further heighten the concerns of policymakers about long-term inflation. Chinese economists approach price theory from a monetarist point of view and, hence, are extremely concerned when currency in circulation shows any kind of sharp upward trend. If recent agricultural policies fail to ease China's subsidization problem and if the movement to institute tax payments instead of profit deliveries takes an unexpectedly large bite out of Chinese revenues,⁶ the budget deficit could burgeon from levels the Chinese already consider too high. Even the most reform-minded Chinese economist would be reluctant to advocate further change in the face of budget deficits approaching the 1979 level of 20 billion yuan. Advocates of a return to tighter central control would press their case with renewed vigor and would use mounting deficits as evidence that the reformers had miscalculated. [redacted]

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Other economic problems—which by themselves are probably not capable of triggering any major policy reversals, but which in conjunction with the more serious problems discussed above could tip the scales in favor of a return to tight central control—include:

- Mounting economic crime—including bribery, fraud, tax evasion, and so forth—at all levels of management and within the party. The Chinese leadership is especially sensitive to this issue because it lends credence to critics arguing that the reforms are capitalist.
- Consecutive years of poor weather which would deprive the reformers of their most powerful evidence of the efficacy of reform, the striking achievements in agriculture.

⁶ Beijing anticipates an immediate annual loss of 3.5 billion yuan as a result of the new tax program. [redacted]

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- Deteriorating terms of trade and increasing imports of goods that Beijing considers wasteful (consumer goods, duplicate purchases of machinery and equipment, and so forth) as a result of further foreign trade decentralization.
- Increased popular unrest over growing income disparities and the sudden acquisition of wealth by a small minority of entrepreneurs.
- Local unemployment problems caused by a failure to manage labor cutbacks well in the name of increased efficiency. [redacted]

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The difficulty China's reformers will have in coping with these problems would be exacerbated greatly by the early death or incapacitation of Deng Xiaoping. Although, by his own admission, Deng no longer involves himself in the day-to-day management of economic policy, his importance to the reformers cannot be overstated. The recent acceleration in the pace of reform indicates that Deng has thrown his political influence behind the new economic policies and that he is, for the time being at least, unwilling to compromise with more conservative leaders such as Chen Yun. [redacted]

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Even under a worst case scenario in which the reformers are forced to give up ground, we do not envision a swing all the way back to the austere, centrally administered, and self-reliant policies of the Mao era. Deng appears to have rid the upper echelons of the party apparatus of supporters of extreme centralism. Many of those presently opposing additional reform were themselves branded "capitalist" in the early 1960s. Policies they advocated then called for some reliance on market mechanisms, albeit on a much smaller scale than is currently recommended. Most of these leaders, if thrust into the topmost position, would continue to pursue exchanges with the West, although perhaps some of the more progressive policies, such as the opening of the 14 coastal cities to foreign commerce, might be discontinued under a more cautious leadership. [redacted]

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